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Director v. Shareholder Primacy in the Convergence Debate

Stephen M. Bainbridge*

Although participants in the convergence debate disagree as to whether international corporate governance is converging on the U.S. model, there is general agreement as to the nature of that model. Henry Hansmann and Reinier Kraakman argue, for example, that corporate governance systems around the world are converging towards “the ‘standard shareholder-oriented model’ of the corporate form,”¹ which they assert has always been the dominant model in the United States and the United Kingdom.² In contrast, while Roberta Romano expresses skepticism about the extent of (and the desirability of) global corporate governance convergence, she too assumes that U.S. jurisdictions tend “to adopt laws that maximize shareholder wealth.”³ In sum, the literature assumes that the U.S. model, towards which global systems are (or are not) converging, is one of shareholder primacy.⁴

This is an error. The term shareholder primacy typically connotes two distinct principles: (1) The shareholder wealth maximization norm, pursuant to which directors are obliged to make a decision based solely on the basis of long-term shareholder gain. This principle is well-established in U.S. corporate law, and for purposes of this essay, may be taken as given;⁵ (2) The principle of

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1. Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 441 (2001).

2. *Id.* at 468.

3. Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2031 (1993).

4. See Douglas M. Branson, *The Very Uncertain Prospect of “Global” Convergence in Corporate Governance*, 34 CORNELL INT’L L.J. 321, 347 (2001) (asserting that “United States academic elites, including the global convergence advocates, seem to hold as universal a view of . . . profit maximization as each firm and the nation’s goal”); Curtis J. Milhaupt, *Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance*, 149 U. PA. L. REV. 2083, 2128 (2001) (noting that “Professors Hansmann and Kraakman have provided a provocative account of one of the principal mechanisms driving corporate convergence: the ascendance of the shareholder primacy norm. . . .”); see, e.g., James A. Fanto, *The Role of Corporate Law in French Corporate Governance*, 31 CORNELL INT’L L.J. 31, 32 (1998) (assuming that “technological changes and the globalization of the economy are pushing corporate governance worldwide towards a U.S.-style market capitalism”); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 330-31 (2001) (citing prior work in which he “extolled the American system because [of] its openness to external monitoring through a stock market-centered capital market”); Jeffrey N. Gordon, *Pathways to Corporate Convergence? Two Steps on the Road to Shareholder Capitalism in Germany*, 5 COLUM. J. EUR. L. 219, 219 (1999) (asking whether “corporate governance will ultimately converge” on the “Anglo-American model whose features are shaped by the shareholder primacy norm”); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001) (opining that “[s]hareholder wealth maximization is usually accepted as the appropriate goal in American business circles”).

5. See *infra* notes 17-19 and accompanying text.

ultimate shareholder control. Although shareholders do not wield day-to-day authority, they purportedly exercise ultimate decisionmaking authority through proxy contests, institutional investor activism, shareholder litigation, and the market for corporate control. Here is where the error lies.

Insofar as control is concerned, U.S. corporate law is far more accurately described as a system of director primacy than one of shareholder primacy. As Berle and Means famously demonstrated, U.S. public corporations are characterized by a separation of ownership and control.⁶ The firm's nominal owners, the shareholders, exercise virtually no control over either day-to-day operations or long-term policy.⁷ Instead, control is vested in the hands of professional managers, who typically own only a small portion of the firm's shares.⁸

The separation of ownership and control is virtually carved into stone by U.S. corporate law. Under all corporation statutes, the vast majority of corporate decisions are assigned to the board of directors or their subordinates acting alone.⁹ Shareholders essentially have no power to initiate corporate action and, indeed, are entitled to approve or disapprove only a very few board actions.¹⁰ The direct restrictions on shareholder power supplied by U.S. corporate law are supplemented by a host of other economic and legal forces that prevent U.S. investors from exercising significant influence over corporate decisionmaking.¹¹

Indeed, if one wants to observe a shareholder primacy model in action, Slovenia would be a better example than the United States. (I use Slovenia herein for comparative purposes because it is a regime with which I have developed some familiarity.) To be sure, Slovenia's corporate law system formally contemplates extensive labor involvement through a system of codetermination modeled on German law.¹² Reportedly, management capture is also a dominant feature of Slovenian firms. All the same, however, privatization of Slovenia's social-owned enterprises was effected by a mandatory allocation of shares to a combination of investment funds, employees, former employees, plus a public sale of shares.¹³ As a result, Slovene corporate share ownership is now bifurcated between large—potentially influential—institutional shareholders and relatively powerless diffuse small holders. The basic building blocks of Slovene corporate

6. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 66 (1932).

7. *Id.* at 82.

8. *Id.*

9. See *infra* notes 39-42 and accompanying text (describing relevant state corporation code provisions).

10. See *infra* notes 21-23 and accompanying text (describing relevant state corporation code provisions).

11. See generally Stephen M. Bainbridge, *Constraints on Shareholder Activism in the United States and Slovenia* (May 17, 2000), available at <http://papers.ssrn.com/sol3/delivery.cfm/00517315.pdf?abstractid=228780> (copy on file with *The Transnational Lawyer*) (summarizing constraints); see also *infra* notes 24-28 and accompanying text.

12. See generally Rado Bohinc & Stephen M. Bainbridge, *Corporate Governance in Post-Privatized Slovenia*, 49 AM. J. COMP. L. 49, 58-60 (2001) (describing labor role).

13. See *id.* at 53-56 (describing the processes by which privatization was effected).

governance thus differ rather dramatically from those of the United States. The groundwork for shareholder primacy has been laid.

The convergence literature's erroneous understanding of the U.S. model distorts both the positive and normative aspects of the convergence debate. On the positive side, if we use the extent of shareholder primacy as our metric, we will end up with a distorted estimate of the extent to which systems have converged.¹⁴ On the normative side, corporate governance is a potentially important instrument by which to increase the economy's efficiency.¹⁵ In recent years, elite U.S. corporate law scholars have played a significant role in "reforming" the corporate laws of transition economies.¹⁶ If the goal is to export the U.S. model, on the assumption of its superiority, we do those economies no good—and may do much harm—by exporting the wrong model.

Does it matter? Is director primacy superior to shareholder primacy? Put another way, should a transitional economy, such as Slovenia, encourage or discourage corporate governance activism by institutional investors? This essay acknowledges that investor participation in corporate governance has economic benefits, but argues that on balance director primacy is preferable.

I. DIRECTOR PRIMACY IN THE UNITED STATES

Although they are often used interchangeably, the terms shareholder primacy and shareholder wealth maximization in fact express quite distinct concepts. The shareholder wealth maximization norm is a basic feature of U.S. corporate governance. In 1919, the Michigan Supreme Court gave the shareholder wealth maximization norm its classic statement: "A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end."¹⁷ Seven decades later, the influential Delaware court of chancery likewise opined: "It is the obligation for directors to attempt, within the law, to maximize the long-run interests of the corporation's

14. Whether global corporate governance systems are in fact converging toward the U.S. model is beyond the scope of this article. Suffice it to say that I am agnostic but skeptical. In my view, Montesquieu's observation that law cannot be expected to develop universal patterns remains highly pertinent even in today's global economy. RUSSELL KIRK, *THE ROOTS OF AMERICAN ORDER* 352 (3d ed. 1991) (quoting Montesquieu: "For men's circumstances vary mightily one from another—affected by climate, by soil, by extent of country, by historic experience, by customs and habits, by strategic situation, by commerce and industry, by religion, by a multitude of other influences. Therefore every people develop their own particular laws, and rightly so").

15. I assume that efficient corporate governance can promote overall economic efficiency, while recognizing that the economic impact of corporate governance reform will often be swamped by other economic factors. For a more skeptical account, see Romano, *supra* note 3, at 2023 (arguing there is no empirical evidence "that corporate governance arrangements affect productivity").

16. See, e.g., Bernard Black et al., *Russian Privatization and Corporate Governance: What Went Wrong*, 52 *STAN. L. REV.* 1731 (2000) (describing the authors' involvement in the failed attempt to rewrite Russian corporate law along U.S. lines).

17. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

stockholders . . .”¹⁸ Despite occasional academic arguments to the contrary, the shareholder wealth maximization norm expounded by these courts indisputably is the law in the United States.¹⁹

Shareholder primacy encompasses the shareholder wealth maximization norm, but adds to it control claims. Shareholder primacy thus contends not only that shareholders are the principals on whose behalf corporate governance is organized, but also that shareholders do (and should) exercise ultimate control of the corporate enterprise. Hence, for example, shareholder primacy assumes shareholder voting rights that are both exclusive and strong.²⁰

In fact, however, shareholder control rights are so weak that they scarcely qualify as part of corporate governance. Under the Delaware code, for example, shareholder voting rights are essentially limited to the election of directors and approval of charter or bylaw amendments, mergers, sales of substantially all of the corporation’s assets, and voluntary dissolution.²¹ As a formal matter, only the election of directors and amending the bylaws do not require board approval before shareholder action is possible.²² In practice, of course, even the election of directors (absent a proxy contest) is predetermined by the existing board nominating the next year’s board.²³

These direct restrictions on shareholder power are supplemented by a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decisionmaking. Three sets of statutes are especially noteworthy: (1) disclosure requirements pertaining to large holders;²⁴ (2) shareholder voting and

18. *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 879 (Del. Ch. 1989).

19. See Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423-25 (1993) (stating: “Despite a smattering of evidence to the contrary, the mainstream of corporate law remains committed to the principles espoused by the *Dodge* court. . . . [T]he shareholder wealth maximization norm thus remains a more accurate description of the state of the law than any of its competitors”); see also David Millon, *New Game Plan or Business as Usual? A Critique of the Team Production Model of Corporate Law*, 86 VA. L. REV. 1001, 1003 (2000) (noting “the widely held view that corporate law currently endorses a principal-agent, shareholder primacy understanding of the board’s responsibility”).

20. See Hansmann & Kraakman, *supra* note 1, at 449 (making that assumption).

21. See MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 174-77 (1995) (summarizing state corporate law on shareholder voting entitlements).

22. DEL. CODE ANN. tit. 8, §§ 109, 211 (2000).

23. See generally Bayless Manning, *The American Stockholder*, 67 YALE L.J. 1477, 1485-89 (1958) (book review) (describing incumbent control of the proxy voting machinery).

24. Securities Exchange Act § 13(d) and the SEC rules thereunder require extensive disclosures from any person or group acting together which acquires beneficial ownership of more than 5% of the outstanding shares of any class of equity stock in a given issuer. 15 U.S.C. § 78m (2001). The disclosures required by § 13(d) impinge substantially on investor privacy and thus may discourage some investors from holding blocks greater than 4.9% of a company’s stock. U.S. institutional investors frequently cite § 13(d)’s application to groups and the consequent risk of liability for failing to provide adequate disclosures as an explanation for the general lack of shareholder activism on their part. Bernard S. Black, *Shareholder Activism and Corporate Governance in the United States*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 459, 461 (1998).

communication rules;²⁵ and (3) insider trading and short swing profits rules.²⁶ These laws affect shareholders in two respects. First, they discourage the formation of large stock blocks.²⁷ Second, they discourage communication and coordination among shareholders.²⁸

Despite the limitations of shareholder voting rights, some scholars argue the market for corporate control ensures a residual form of shareholder control, transforming “the limited de jure shareholder voice into a powerful de facto form of shareholder control.”²⁹ To be sure, the market for corporate control depends on the existence of shareholder voting rights. Moreover, the market for corporate control doubtless is an important accountability mechanism.³⁰ Market-based accountability and control—by which I mean the right to exercise decisionmaking fiat—are distinct concepts, however. Directors are held accountable to shareholders through a variety of market forces, such as the capital and reputational markets, but one cannot fairly say that those markets confer control rights on the shareholders. How then can one say that the market for corporate control does so? The right to fire is not the right to exercise fiat—it is only the right to discipline. In any event, takeover defenses—especially the combination of a poison pill and a classified board—go a long way towards restoring director primacy vis-à-vis the shareholders.³¹

25. To the extent shareholders exercise any control over the corporation, they do so only through control of the board of directors. As such, it is the shareholders' ability to affect the election of directors that determines the degree of influence they will hold over the corporation. The proxy regulatory regime discourages large shareholders from seeking to replace incumbent directors with their own nominees. See Stephen M. Bainbridge, *Redirecting State Takeover Laws at Proxy Contests*, 1992 WIS. L. REV. 1071, 1075-84 (describing incentives against proxy contests). It also discourages shareholders from communicating with one another. See Stephen Choi, *Proxy Issue Proposals: Impact of the 1992 SEC Proxy Reforms*, 16 J.L. ECON. & ORG. 233 (2000) (explaining that liberalization of the proxy rules has not significantly affected shareholder communication practices).

26. See Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 HARV. J.L. & PUB. POL'Y 671, 712-13 (1995) (noting insider trading concerns raised by shareholder activism).

27. Large block formation may also be discouraged by state corporate law rules governing minority shareholder protections. Under Delaware law, a controlling shareholder has fiduciary obligations to the minority. See, e.g., *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947). A controlling shareholder who uses its power to force the corporation to enter into contracts with the shareholder or its affiliates on unfair terms can be held liable for the resulting injury to the minority. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971). A controlling shareholder who uses its influence to effect a freeze-out merger in which the minority shareholders are bought out at an unfairly low price likewise faces liability. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

28. For a more detailed treatment of the effects of these statutes on shareholder control, see Bainbridge, *supra* note 11.

29. John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 850-51 (1999).

30. See generally Henry Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965), which is the seminal work on the market for corporate control as a means of corporate accountability. See William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999); Fred S. McChesney, Manne, *Mergers and the Market for Corporate Control*, 50 CASE W. RES. L. REV. 245 (1999).

31. See Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory*

Other scholars have argued that institutional investor activism can give real teeth to shareholder control.³² Acknowledging that the rational apathy phenomenon precludes small individual shareholders from playing an active role in corporate governance, even if the various legal impediments to shareholder activism were removed, these scholars focused their attention on institutional investors, such as pension and mutual funds. Institutional investors, at least potentially, may behave quite differently than dispersed individual investors. Because they own large blocks and have an incentive to develop specialized expertise in making and monitoring investments, they could play a far more active role in corporate governance than dispersed shareholders. Institutional investors holding large blocks thus have more power to hold management accountable for actions that do not promote shareholder welfare. Their greater access to firm information, coupled with their concentrated voting power, might enable them to more actively monitor the firm's performance and make changes in the board's composition when performance lagged.

There is relatively little evidence that institutional investor activism has mattered, however. Due to a resurgence of direct individual investment in the stock market, motivated at least in part by the day trading phenomenon and the technology stock bubble, the trend towards institutional domination has stagnated. Although about fifty percent of equity securities are owned by institutions, large blocks held by a single investor are rare, and few U.S. corporations have any institutional shareholders who own more than five-to-ten percent of their stock.³³ Even the most active institutional investors spend only trifling amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions.³⁴ They rarely conduct proxy solicitations or put forward shareholder proposals.³⁵ Not surprisingly, empirical studies of U.S. institutional investor activism have found "no strong evidence of a correlation between firm performance and percentage of shares owned by institutions."³⁶

Competition, 87 VA. L. REV. 111, 125-26 (2001) (discussing effectiveness of pill-classified board combination as a means of ensuring continued board control); see also Robert B. Thompson, *Shareholders as Grown-Ups: Voting, Selling, and Limits on the Board's Power to "Just Say No,"* 67 U. CIN. L. REV. 999, 1017-18 (1999) (using legal treatment of poison pill and classified board provisions as a measure of jurisdictional commitment to shareholder primacy).

32. See, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990). For more skeptical analyses, see Edward Rock, *The Logic and Uncertain Significance of Institutional Investor Activism*, 79 GEO. L.J. 445 (1991); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795 (1993); Robert D. Rosenbaum, *Foundations of Sand: The Weak Premises Underlying the Current Push for Proxy Rule Changes*, 17 J. CORP. L. 163 (1991).

33. See Black, *supra* note 32, at 567-68 (summarizing data).

34. See Black, *supra* note 24, at 460 (noting that even "activist institutions spend less than half a basis point of assets . . . on their governance efforts").

35. *Id.*

36. *Id.* at 462.

In sum, shareholders are almost wholly lacking in either direct or indirect mechanisms of control. Likewise, there is little evidence of effective shareholder demand for such control. Instead, control is vested in the board of directors. To be sure, former Delaware Chancellor William Allen once opined that “our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters.”³⁷ In fact, however, under U.S. corporate law the board of directors is not a mere agent of the shareholders, but rather is a *sui generis* body—indeed, a sort of Platonic guardian³⁸—serving as the nexus for the various contracts making up the corporation.

Under all state corporation codes, the key players in the statutory decision making structure are the corporation’s directors.³⁹ As the Delaware code puts it, the corporation’s business and affairs “shall be managed by or under the direction of a board of directors.”⁴⁰ The vast majority of corporate decisions accordingly are made by the board of directors alone (or by managers acting under delegated authority).⁴¹ The statutory decision making model thus is one in which the board acts and shareholders, at most, react. Put simply, control is vested in the board—not the shareholders.⁴²

To be sure, it is often said that, in the real world, boards are captured by senior management. According to this view, senior “managers dominate their boards by using their de facto power to select and compensate directors and by exploiting personal ties with them.”⁴³ The board capture phenomenon seems less valid today, however, than it once was. During the 1980s and 1990s, several

37. *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988).

38. See PLATO, *THE REPUBLIC* 289-90 (Benjamin Jowett trans., 1991). In which Socrates describes the education of philosopher-kings who rule “for the public good, not as though they were performing some heroic action, but simply as a matter of duty.” *Id.*

39. All state corporate codes provide for a system of nearly absolute delegation of power to the board of directors, which in turn is authorized to further delegate power to subordinate firm agents. See MODEL BUS. CORP. ACT ANN. § 8.01 at 8-10 to 8-11 (1995) (reviewing statutes).

40. DEL. CODE ANN. tit. 8, § 141(a) (2001). Of course, operational decisions normally are delegated by the board to subordinate employees. The board, however, retains the power to hire and fire firm employees and to define the limits of their authority. Moreover, certain extraordinary acts may not be delegated, but are instead reserved for the board’s exclusive determination. See, e.g., *Lee v. Jenkins Bros.*, 268 F.2d 377 (2d Cir. 1959); *Lucy v. Hero Int’l Corp.*, 281 N.E.2d 266 (Mass. 1972).

41. The word “decision” is used herein for semantic convenience to describe a process that often is much less discrete in practice. Most board of director activity “does not consist of taking affirmative action on individual matters; it is instead a continuing flow of supervisory process, punctuated only occasionally by a discrete transactional decision.” Bayless Manning, *The Business Judgment Rule and the Director’s Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984).

42. The board of directors as an institution of corporate governance, of course, does not follow inexorably from the necessity for fiat. After all, an individual chief executive could serve as the hypothesized central coordinator. Yet, corporate law vests ultimate control in the board. Why? I have elsewhere suggested two answers to that question: (1) under certain conditions, groups make better decisions than individuals and (2) group decisionmaking is an important constraint on agency costs. Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002).

43. Barry Baysinger & Robert E. Hoskisson, *The Composition of Boards of Directors and Strategic Control: Effects on Corporate Strategy*, 15 ACAD. MGMT. REV. 72, 72-73 (1990).

trends coalesced to encourage more active and effective board oversight. Much director compensation is now paid in stock, for example, which helps align director and shareholder interests.⁴⁴ Courts have made clear that effective board processes and oversight are essential if board decisions are to receive the deference traditionally accorded to them under the business judgment rule, especially insofar as structural decisions are concerned (such as those relating to management buy-outs).⁴⁵ Director conduct is constrained by an active market for corporate control, ever-rising rates of shareholder litigation, and some say—albeit erroneously, activist shareholders.⁴⁶ As a result, modern boards of directors typically are smaller than their antecedents, meet more often, are more independent from management, own more stock, and have better access to information. These developments culminated in a series of high-profile board revolts against incumbent managers at such iconic American corporations as General Motors, Westinghouse, and American Express.⁴⁷ More recently, the firing of “Chainsaw Al” Dunlap by Sunbeam’s board provides yet more anecdotal evidence of board activism.⁴⁸

In any event, the institutional structure created by corporate law allows, but does not contemplate, a one-man rule. If it comes to overt conflict between the board and top management, the board’s authority prevails as a matter of law, if not always in practice. Indeed, it is the necessity for retaining dismissal of senior management as a potential sanction that explains why the board is at the apex of the corporate hierarchy rather than functioning as an advisory committee off to the side of the corporate organizational chart. One can imagine a structure of corporate authority identical to current norms except that the board acts as a mere advisory body to a single autocratic CEO. On the face of it, such a structure seemingly would preserve most advantages of the current structure. Consequently, it

44. Charles M. Elson, *Director Compensation and the Management-Captured Board: The History of a Symptom and a Cure*, 50 SMU L. REV. 127 (1996).

45. See Stephen M. Bainbridge, *Independent Directors and the ALI Corporate Governance Project*, 61 GEO. WASH. L. REV. 1034, 1068-81 (1993) (describing how judicial review of management buyouts and other conflict of interest transactions focuses on the role of independent directors).

46. Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489 (1999). For skepticism as to the latter claim, see *supra* notes 33-36 and related discussion (positing minimal corporate governance influence by activist institutional investors).

47. See Ira M. Milstein, *The Evolution of the Certifying Board*, 48 BUS. LAW. 1485, 1489-90 (1993) (discussing such cases). As boards become stronger and more independent of top management, moreover, the process builds momentum. For example, James Westphal and Edward Zajac have demonstrated that as board power increases relative to the CEO, newly appointed directors become more demographically similar to the board. James D. Westphal & Edward J. Zajac, *Who Shall Govern? CEO/Board Power, Demographic Similarity, and New Director Selection*, 40 ADMIN. SCI. Q. 60 (1995) (measuring power by such factors as the percentage of insiders and whether the CEO also served as chairman; cautioning that CEO control over director selection remains the general rule).

48. See Dana Canedy, *Sunbeam’s Board, in Revolt, Ousts Job-Cutting Chairman*, N.Y. TIMES, June 16, 1998, at A1. In most cases, of course, board oversight tends to be both less dramatic and more informal. Individual directors pass concerns onto the CEO, who in turn bounces ideas off board members. Rather than struggling to overcome the collective action problems that impede firing a CEO, an individual director tries to obtain better performance through a private reprimand.

is the board's power to hire and fire senior management that explains their position at the apex of the corporate hierarchy. In turn, that position is why U.S. corporate law is better described as a system of director primacy than one of either shareholder or managerial primacy.

II. THE POTENTIAL FOR SHAREHOLDER PRIMACY IN SLOVENIA

Shortly after achieving independence from the former Yugoslav federation, Slovenia adopted a new corporation law—the Law on Commercial Companies—to replace the former Enterprise Law.⁴⁹ The new law was modeled mainly on the German Aktiengesetz statute, along with various other German and Austrian precedents, rather than on Anglo-American corporation law.⁵⁰ Unlike U.S. corporate law, Slovenian corporate law thus includes many features of German or Austrian corporations, especially a codetermination-based system of corporate governance including a two-tier governance system with employee participation on both the supervisory board and the management board.⁵¹

As a matter of formal statutory law, Slovenian corporation law thus vests substantial power in labor representatives. At the plant level, work councils elect labor representatives to the corporation's supervisory and management boards, as well as have a voice in local plant issues.⁵² In companies with fewer than one thousand employees, at least one-third of the supervisory board's members must be employee representatives.⁵³ In companies with more than one thousand employees, at least half of the members must be employee representatives.⁵⁴ The statute also mandates a labor representative on the management board of all corporations with more than five hundred employees, who is charged with representing workers' interests with respect to personnel and social matters.⁵⁵ As

49. Bohinc & Bainbridge, *supra* note 12, at 49. The Enterprise law had been enacted during the last years of former Yugoslavia to reintroduce—after five decades of state and social ownership—a capitalist, free market, property rights-based corporate law. *Id.* Corporation-like firms under the former system were labor-managed or self-managed and, as such, were not comparable with U.S.-style capital-owned firms. *Id.* at 49 n.2.

50. *Id.* at 49. It is conventional to bifurcate corporate governance systems between the U.S.-style market-oriented model with an active capital market and diffuse ownership and the German-style bank-oriented model with a less active capital market and highly concentrated ownership. Gustavo Visentini, *Compatibility and Competition Between European and American Corporate Governance: Which Model of Capitalism?*, 23 BROOK. J. INT'L L. 833 (1998). Due to the high degree of institutional ownership, Slovenia's current system is closer to the bank-centered model. A principal difference between the Slovene and German models, however, is that in the former banks are only one category of important institutions. Bohinc & Bainbridge, *supra* note 13, at 57 n.31.

51. On the distinction between management and supervisory boards, and employee entitlement to representation thereon, see Bohinc & Bainbridge, *supra* note 13, at 58-60.

52. See *id.* at 59 (noting role of works council in nominating board members).

53. *Id.* at 58-59.

54. *Id.* at 59.

55. *Id.*

a formal matter, Slovenian corporate law thus stands as a counterfactual to the pro-convergence position.⁵⁶

As a practical matter, however, the potential for shareholder primacy—or, more precisely, ultimate shareholder control—lurks within the structure of Slovenian corporate governance. Although precise data on the degree of institutional ownership apparently is not available, there seems no doubt that privatization resulted in substantial institutional ownership of Slovene corporations.⁵⁷ All of the methods by which Slovenian firms were privatized required that forty percent of the newly formed corporation's shares be issued to three state-controlled investment funds.⁵⁸ One of those funds, the state development fund, subsequently exchanged a substantial amount of ownership certificates to investment companies that had been expressly formed to trade in privatized corporation shares.⁵⁹ Finally, institutional investors have been actively acquiring those shares originally issued to the public and employees. An empirical survey by the Research Center for Legal Comparative and Development Studies at the University of Ljubljana found a substantial decrease of the number of shareholders in each corporation, probably resulting from the selling of shares by small holders.⁶⁰ According to one estimate, about eighty percent of Slovenian equities are now controlled by a relatively small number of institutions—pension funds, banks, insurance and investment companies, and state-controlled funds.⁶¹

In addition to the sheer size of their holdings, at least three other factors further enhance the power of Slovene institutional investors. First, it has become commonplace for large holders to enter into informal shareholder agreements pursuant to which they act in concert.⁶² This effectively further concentrates ownership by linking large block holders. Second, small holders have no experience, knowledge, or tradition of ownership. They do not participate at shareholder meetings, even by proxy, and thus lack any meaningful voice.⁶³ Finally, despite the formal statutory mandates, few corporations have appointed labor representatives to the management board.

Unlike the U.S. model in which ownership and control are separated, Slovenian corporate governance thus potentially resembles what Berle and Means called minority control. Such control exists where “a small group hold[s] a sufficient stock interest to be in a position to dominate a corporation *through their stock interest*.”⁶⁴ Consistent with this hypothesis, Slovene institutional investors increasingly

56. See Branson, *supra* note 4, at 328 (pointing to the “conscious choice in post-privatized Slovenia for extensive labor involvement” as evidence demonstrating “a decided lack of convergence”).

57. For a description of the privatization process, see Bohinc & Bainbridge, *supra* note 12, at 53-56.

58. *Id.* at 56.

59. *Id.*

60. *Id.* at 56-57 n.30.

61. Bainbridge, *supra* note 11.

62. *Id.*

63. *Id.*

64. BERLE & MEANS, *supra* note 6, at 75.

pursue an active role in corporate governance and decisionmaking.⁶⁵ Indeed, these institutions are becoming quite aggressive, in the sense of intervening even in how management boards make day-to-day business decisions. They control the composition of the supervisory board and exercise *de facto* control over the selection of management board members, as well as bringing informal pressure to bear on the management board's conduct of the business.⁶⁶

III. DOES IT MATTER? THE NORMATIVE APPEAL OF DIRECTOR PRIMACY

The separation of ownership and control characteristics of U.S. corporations has costs, as Berle and Means recognized more than six decades ago: "The separation of ownership from control produces a condition where the interests of owner and of ultimate manager may, and often do, diverge"⁶⁷ Modern scholars refer to the consequences of these divergences as agency costs, which are conventionally defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents.⁶⁸ In turn, shirking is conventionally defined to include any action by a member of a production team that diverges from the interests of the team as a whole. As such, shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes.⁶⁹

A sole proprietorship with no agents will internalize all costs of shirking because the proprietor's optimal tradeoff between labor and leisure is, by definition, the same as the firm's optimal tradeoff.⁷⁰ Agents of a firm will not internalize all of the costs of shirking, however, because the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking.⁷¹ Alchian and Demsetz offered the useful example of two workers who jointly lift heavy boxes into a truck.⁷² The marginal productivity of each worker is very difficult to measure and their joint output cannot be easily separated into individual components.⁷³ In such situations, obtaining information about a team

65. Bainbridge, *supra* note 11.

66. Bohinc & Bainbridge, *supra* note 13, at 57.

67. BERLE & MEANS, *supra* note 6, at 7.

68. See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 304 (1983) (defining agency costs). See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (setting out agency cost economics).

69. Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 465 (1992).

70. See Jensen & Meckling, *supra* note 68, at 312-13 (explaining incentives of owner-manager of a wholly owned firm).

71. See *id.* at 313 (noting that the incentive to appropriate perquisites rises as the manager's fractional ownership share falls).

72. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972).

73. *Id.* at 780.

member's productivity and appropriately rewarding each team member therefore are very difficult and costly. In the absence of such information, however, the disutility of labor gives each team member an incentive to shirk because the individual's reward is unlikely to be closely related to conscientiousness.⁷⁴

Although agents *ex post* have strong incentives to shirk, *ex ante* they have equally strong incentives to agree to a corporate contract containing terms designed to prevent shirking.⁷⁵ Bounded rationality, however, precludes firms and agents from entering into the complete contract necessary to prevent shirking by the latter.⁷⁶ Instead, there must be some system of *ex post* governance: some mechanism for detecting and punishing shirking. Accordingly, an essential economic function of management is monitoring the various inputs into the team effort. Specifically, management meters the marginal productivity of each team member and then takes steps to reduce shirking.⁷⁷

The Alchian and Demsetz model, as they recognized, forces one to examine the question: who will monitor the monitors?⁷⁸ In any team organization, one must have some ultimate monitor who has sufficient incentives to ensure firm productivity without himself having to be monitored. Otherwise, one ends up with a never-ending series of monitors monitoring lower level monitors.⁷⁹ Alchian and Demsetz solved this dilemma by consolidating the roles of ultimate monitor and residual claimant.⁸⁰ If the constituent entitled to the firm's residual income is given final monitoring authority, he is encouraged to detect and punish shirking by the firm's other inputs because his reward will vary exactly with his success as a monitor.

Unfortunately, this elegant theory breaks down precisely where it would be most useful. Because of the separation of ownership and control, it simply does not describe the modern publicly-held U.S. corporation. As the corporation's residual claimants, the shareholders should act as the firm's ultimate monitors.⁸¹ But while U.S. law provides shareholders with some enforcement and electoral rights, these are quite limited.⁸² In general, as we have seen, shareholders of public U.S. corporations have neither the legal right, the practical ability, nor the

74. See *id.* (explaining how monitoring and related costs give "each person [an incentive] to take more leisure").

75. See Jensen & Meckling, *supra* note 68, at 325-26 (discussing incentives for agents to incur bonding costs).

76. See generally OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 30-32, 45-46 (1985) (defining bounded rationality and describing its effects on the contracting process).

77. Alchian & Demsetz, *supra* note 72, at 794.

78. *Id.* at 782.

79. See Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863, 874 n.38 (1991) (quoting a story by Dr. Suess illustrating the problem).

80. Alchian & Demsetz, *supra* note 72, at 782.

81. See *id.* at 787-89 (discussing corporate form).

82. See *supra* notes 21-22 and accompanying text (describing shareholder electoral rights).

desire to exercise the kind of control necessary for meaningful monitoring of the corporation's agents.⁸³

As noted above, during the late 1980s and early 1990s, some scholars argued that the rising importance of institutional investors would change the analysis.⁸⁴ Corporations with large blocks of stock held by institutional investors thus would come to resemble Alchian and Demsetz's firm, in which the residual claimants act as the ultimate monitor of the firm's agents. As a result, concentrated ownership in the hands of institutional investors would lead to a reduction in shirking and, hence, a reduction in agency costs. In turn, that should lead to a more efficient economy. Or so the story went. As we have seen, however, there is relatively little evidence that institutional activism has mattered other than at the margins.⁸⁵

Some former advocates of institutional investor activism have therefore retreated to the more modest claim that "it's hard to be against institutional investor activism."⁸⁶ Yet, even this last revisionist redoubt fails to adequately acknowledge that the purported benefits of institutional control, if any, may come at too high a cost. As even one of the most prominent proponents of institutional investor activism conceded, for example, there is good evidence that bank control of the securities markets has harmed the Japanese and German economies by impeding the development of new businesses.⁸⁷ Unfortunately, the same may prove true in our case study—*i.e.*, Slovenia. Although a large number of new corporations have been formed in Slovenia post-privatization, they are economically insignificant both individually and collectively.⁸⁸ The substantial institutionalization of the Slovene markets thus may impede development of the sort of active venture capital market that drives the U.S. economy.

Because we are concerned with the governance of large publicly held corporations, however, this essay focuses on a different concern—namely, the risk that institutional investors may abuse their control by self-dealing and other forms of over-reaching. In his important study of institutional ownership, Mark Roe contended that large block holders can improve firm performance by personifying the shareholder community.⁸⁹ He argued that loyalty to real people may be a better motivator than loyalty to an abstract collection of small shareholders.⁹⁰ The trouble, of course, is that the interests of large and small investors often differ.⁹¹ If the board becomes more

83. See *supra* notes 21-36 and accompanying text (identifying the legal limits on shareholder power).

84. See *supra* note 32 and accompanying text; see also Branson, *supra* note 4, at 322 (arguing that elite corporate law scholarship tends to be faddish and specifically criticizing those "scholars [who] wrote about, and subsequently oversold, institutional investor activism").

85. See *supra* notes 34-36 and accompanying text.

86. Black, *supra* note 24, at 462.

87. ROE, *supra* note 32, at 256.

88. Bohinc & Bainbridge, *supra* note 12, at 56 n.29.

89. ROE, *supra* note 32, at 237-38.

90. *Id.*

91. Rock, *supra* note 32, at 466-68; Rosenbaum, *supra* note 32, at 176-79.

beholden to the interests of large shareholders, it may become less concerned with the welfare of smaller investors.

Again, the Slovenian example is instructive. An initial source of concern is the continuing presence of state-controlled funds as very large shareholders in nominally privatized Slovene corporations.⁹² As an owner, the state acts in much the same way as other institutional owners; *i.e.*, it is an active participant, especially in industrial sectors having a public interest. In such firms, the state combines its function as a stockholder with its role as a regulator. This combination threatens to subordinate corporate decisions to political goals. There is great danger of political interference not only in large corporate policy, but even in day-to-day business and personnel questions. The adverse economic impact of continuing state ownership is evidenced in a recent empirical study of several Central and Eastern European nations, including Slovenia, finding that enterprises that had been fully privatized for at least four years increased their productivity three-to-five times faster than enterprises that are still state-owned.⁹³

A second (and more general) concern is that institutional investors will be tempted to use their position to self-deal, *i.e.*, to take a non-pro rata share of the firms assets and earnings. There is substantial evidence that the risk of self-dealing by large institutional investors is a very serious one. In the United States, for example, there was considerable looting in the turn of the century insurance industry, as insurance company managers obtained low-interest loans and jobs from portfolio firms.⁹⁴ In Russia, privatization during the 1990s resulted in a “kleptocracy” of controlling investors who have engaged in rampant self-dealing.⁹⁵ In the Czech Republic, post-privatization consolidation of stock ownership likewise led to widespread looting of privatized enterprises by their controlling shareholders.⁹⁶

Let us make the heroic assumption, however, that institutional investors are entirely selfless. Institutional investor activism would still be undesirable if the separation of ownership and control mandated by U.S. law has substantial efficiency benefits. Questions of whether differing corporate law regimes confer comparative advantages on national economies are sharply debated, and the relative merits of the various national models are vigorously disputed even among those who

92. See *supra* note 58 and accompanying text.

93. Gerhard Pohl et al., *Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options*, World Bank Technical Paper No. 368 (1997), available at <http://www.worldbank.org/html/fpd/notes/123/123pohl.pdf> (copy on file with *The Transnational Lawyer*).

94. ROE, *supra* note 32, at 67.

95. Black et al., *supra* note 16, at 1746.

96. John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*, 25 J. CORP. L. 1, 10 (1999). On the other hand, Edwards and Weichenrieder argue that the economic benefits of concentrated ownership in the German economy have outweighed its costs. See Jeremy Edwards & Alfons Weichenrieder, *Ownership Concentration and Share Valuation: Evidence From Germany* (1999), available at http://www.papers.ssrn.com/paper.taf?abstract_id=175333 (copy of file with *The Transnational Lawyer*).

think that corporate law matters insofar as national productivity and competitiveness are concerned. Yet, while the matter undoubtedly remains unproven, there are sound reasons to suspect that the U.S. model has significant advantages.

Berle and Means, of course, believed that the separation of ownership and control was both a departure from historical norms and a serious economic problem.⁹⁷ They likely were wrong on the former score, although that is a question beyond the scope of this essay.⁹⁸ As to the latter, the separation of ownership and control is a highly efficient solution to the decisionmaking problems faced by large corporations.

This essay's normative justification of director primacy is grounded in Kenneth Arrow's work on organizational decisionmaking, which identified two basic decisionmaking mechanisms: "consensus" and "authority."⁹⁹ Consensus is utilized where each member of the organization has identical information and interests, which facilitates collective decisionmaking. In contrast, authority-based decisionmaking structures arise where team members have different interests and amounts of information. Because collective decisionmaking is impracticable in such settings, authority-based structures are characterized by the existence of a central agency to which all relevant information is transmitted and which is empowered to make decisions binding on the whole.¹⁰⁰

Decisionmaking systems in small business firms typically resemble Arrow's consensus model.¹⁰¹ As firms grow in size, however, consensus-based decisionmaking systems become less practical. By the time we reach the publicly held corporation, their use becomes essentially impractical.¹⁰² Indeed, the modern public corporation precisely fits Arrow's model of an authority-based decisionmaking structure.¹⁰³ Shareholders have neither the information nor the incentives necessary to make sound decisions on either operational or policy questions.¹⁰⁴ Overcoming the collective action problems that prevent meaningful shareholder involvement would be difficult and costly.¹⁰⁵ Rather, shareholders will prefer to irrevocably delegate decisionmaking authority to some smaller group.¹⁰⁶ Separating ownership

97. BERLE & MEANS, *supra* note 6, at 3-10 (discussing a perceived transition in the nature of the corporation and describing the purported consequences thereof).

98. The classic debunking of Berle and Means' historical account remains Walter Werner, *Corporation Law in Search of its Future*, 81 COLUM. L. REV. 1611 (1981).

99. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 68-70 (1974).

100. *Id.* at 68-69.

101. See Dooley, *supra* note 69, at 466-67 (applying Arrow's model to partnerships).

102. See generally Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 DEL. J. CORP. L. 979, 1055-75 (1998) (explaining the necessity of authority-based governance in public corporations).

103. Dooley, *supra* note 69, at 467-68.

104. See Bainbridge, *supra* note 102, at 1057-60 (identifying the conflicting interests and access to information of corporate constituents).

105. *Id.* at 1056.

106. As Arrow explains, under conditions of disparate access to information and conflicting interests, it is "cheaper and more efficient to transmit all the pieces of information to a central place" and to have the central

and control by vesting decisionmaking authority in a centralized entity distinct from the shareholders thus makes the large public corporation feasible.

To be sure, this separation results in the agency cost problem described above. A narrow focus on agency costs, however, easily can distort one's understanding. Corporate directors operate within a pervasive web of accountability mechanisms that substitute for monitoring by residual claimants. Important constraints are provided by a variety of market forces. The capital and product markets, the internal and external employment markets, and the market for corporate control all constrain shirking by firm agents.

An even more important consideration, however, is that agency costs are the inevitable consequence of vesting discretion in someone other than the residual claimant. We could substantially reduce, if not eliminate, agency costs by eliminating discretion; that we do not do so suggests that discretion has substantial virtues. A complete theory of the firm thus requires one to balance the virtues of discretion against the need to require that discretion be used responsibly.¹⁰⁷ Neither discretion nor accountability can be ignored, because both promote values essential to the survival of business organizations. Unfortunately, however, they also are antithetical—at some point, one cannot have more of one without also having less of the other. This is so because the power to hold to account is ultimately the power to decide. As Kenneth Arrow explained:

[Accountability mechanisms] must be capable of correcting errors but should not be such as to destroy the genuine values of authority. Clearly, a sufficiently strict and continuous organ of [accountability] can easily amount to a denial of authority. If every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem.¹⁰⁸

Hence, directors cannot be held accountable without undermining their discretionary authority. Establishing the proper mix of discretion and accountability thus emerges as the central corporate governance question.

The root economic argument against shareholder activism thus becomes apparent. Large-scale investor involvement in corporate decision making seems likely to disrupt the very mechanism that makes the public corporation practicable; namely, the centralization of essentially nonreviewable decisionmaking authority in the board of directors. The chief economic virtue of the public corporation is not

office "make the collective choice and transmit it rather than retransmit all the information on which the decision is based." ARROW, *supra* note 99, at 68-69. In the dominant M-form corporation, the board of directors and the senior management team function as that central office. See Bainbridge, *supra* note 102, at 1009 (discussing M-form corporation).

107. Cf. Dooley, *supra* note 69, at 471 (arguing that the business judgment rule reflects a tension between "conflicting values" he refers to as "authority" and "responsibility").

108. ARROW, *supra* note 99, at 78.

that it permits the aggregation of large capital pools, as some have suggested,¹⁰⁹ but rather that it provides a hierarchical decisionmaking structure well-suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In such a firm, someone must be in charge: "Under conditions of widely dispersed information and the need for speed in decisions, authoritative control at the tactical level is essential for success."¹¹⁰ While Roe argues that shareholder activism "differs, at least in form, from completely *shifting* authority from managers to" institutions,¹¹¹ it is in fact a difference in form only. Shareholder activism necessarily contemplates that institutions will review management decisions, step in when management performance falters, and exercise voting control to effect a change in policy or personnel. For the reasons identified above, giving institutions this power of review differs little from giving them the power to make management decisions in the first place.¹¹² Even though institutional investors probably would not micromanage portfolio corporations, vesting them with the power to review major decisions inevitably shifts some portion of the board's authority to them.

Given the significant virtues of discretion, one ought not lightly interfere with management or the board's decisionmaking authority in the name of accountability. Preservation of managerial discretion should always be the null hypothesis. The separation of ownership and control mandated by U.S. corporate law has precisely that effect. If U.S.-style corporate governance is an appropriate model towards which international systems ought to converge, as many players in the convergence debate assert,¹¹³ the goal of convergence must be director—not shareholder—primacy.

IV. CONCLUSION

The difference between director and shareholder primacy matters. The convergence debate is descriptively flawed because it assumes that the U.S. model towards which global corporate governance systems are (or are not) converging is one based shareholder primacy. It is not. Insofar as shareholder primacy contemplates ultimate shareholder control, U.S. corporate law is not characterized by shareholder primacy. Instead, the U.S. model is one of director primacy. Directors act and shareholders, at most, react. The convergence debate is prescriptively flawed insofar as it claims transition economies (or established bank-centered economies, for that matter) ought to embrace shareholder primacy. If U.S.-style corporate governance has systemic economic advantages, those

109. See ROE, *supra* note 32, at 3-4 (summarizing this argument).

110. ARROW, *supra* note 99, at 69.

111. ROE, *supra* note 32, at 184 (emphasis in original).

112. See *supra* note 108 and accompanying text.

113. See Branson, *supra* note 4, at 350-52 (asserting that elite academic proponents of convergence have failed to adequately anticipate backlash against "American economic imperialism").

advantages are attributable not to shareholder primacy but to the numerous legal regimes that enforce director primacy.